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The Stock Market and the Implications of Trump's Election

The surprise election of Donald Trump will profoundly affect the US and world economies. Will his expected policies impact individual companies and industries differently? The stock market says yes, and predicts these different impacts, identifying relative winners and losers.

The election of Donald J. Trump as the 45th President of the United States of America on 8 November 2016 surprised most observers. On the morning of Election Day, Trump's chances were 17 percent with Betfair and 28 percent with 538Silver. Such low odds on outcome Trump victory, combined with the significant policy differences between the two candidates, led to substantial reactions from financial markets. Such reactions can be used to infer markets' assessment of relative winners and losers following the result. Specifically, if the market responds optimally to a surprise, the change in the market price of any asset will reflect both the difference in its expected discounted future payoff between the two possible outcomes and the pre-event probability of the outcome.

"How stock prices reacted to the result says a great deal about shifts in investor expectations regarding growth, taxes, and trade policy."

Capitalizing on this insight, three authors including SFI's Alexander Wagner investigate the differential performance of S&P 500 stocks from the day after the election through year-end 2016. The reaction of company stock prices to the election result reflects shifts in investor expectations with regard to economic growth, taxes, and trade policy. This information is useful for investors as well as for corporate decision-makers who are grappling with how they should prepare for the new administration's upcoming policies.

Three of the main findings of the paper are as follows: First, even after controlling for the rally in the broad market, several low-beta industries (beer, tobacco, food products, and utilities) were among the losers, while cyclical industries tended to be winners. Presumably, expectations of higher growth induced investors to rotate from low-risk to high-beta industries. Interestingly, the cumulative abnormal returns for several industries—from the election to year-end—differ substantially from the immediate response after the election. For example, apparel and textiles, which are the worst performers during the overall period, dropped only modestly on the day after the election. By contrast, markets seem to have been initially too optimistic about the prospects for the steel industry, and they barely reacted at the outset to the prospect of deregulation in the financial industry. There are various possible explanations for this delayed-reaction phenomenon. The authors conclude that the most plausible one is that the market's assessment of the strength and/or likelihood of some of the incoming administration's future policies changed after the election, or took more time to be incorporated into prices because processing the information on these policies was more difficult.

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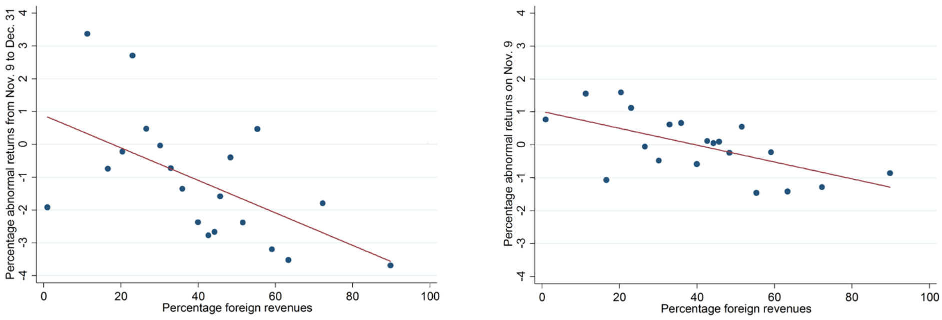
Second, while the details of any future tax plan remain hazy, it is clear that President Trump wants to cut corporate taxes to significantly below their current 35 percent level. Had Hillary Clinton won the election, corporate taxes might well have been trimmed, but not cut to nearly the level that Trump has proposed, namely 15 percent. The paper's analysis reveals that expectations of significant corporate tax cuts boosted high-tax firms, but hurt firms with significant net operating loss carryforward balances. Interestingly, a substantial portion of the overall tax-related reaction was already reflected in stock prices from day one.

Third, how did the market vote on predominantly domestic stocks versus those substantially oriented to the world economy? There are several expectations with regard to policy that suggest that stocks with a domestic focus should have fared better. First, market participants may simply have higher expectations for US growth versus foreign growth. Second, such stocks are less at risk from trade wars that involve retaliation by other countries. Third, Trump's infrastructure plan would naturally benefit domestically focused firms. Fourth, Trump's expansionist fiscal policies, particularly severe cuts in taxes, should foster inflation. Domestic profits would increase; exports would be hurt. On the other hand, some have argued that the VAT flavor of the House Republicans' tax plan will help make US companies more competitive abroad. If so, that would relatively favor internationally oriented stocks.

> "The stock market can tell us something about the future for internationally facing US enterprises."

The stock market's reaction implies clearly negative expectations regarding the anticipated policies' impact on internationally oriented US firms, as the figure below shows. Here, all stocks are sorted into 20 equal-sized bins by their foreign revenues. The effects are sizable. For example, comparing two otherwise similar firms, the one that had a one standard deviation higher fraction of foreign revenues than the other had a 0.96 percentage point lower first-day return, and a 2.15 percentage point lower cumulative abnormal return through year-end.



Binned scatter plot of percentage of foreign revenues against abnormal returns of S&P 500 firms from November 9 to December 31, 2016 (left panel) and abnormal returns on November 9, 2016 (right panel). Source: Wagner, Zeckhauser, and Ziegler (2017).

Additional results show that companies with high interest expenses suffered for two possible reasons: deductions lose value when taxes are slashed, and some Trump/Republican plans threaten interest deductibility. Interestingly, the market reflected shareholders' belief that the proposal to make capital investments immediately deductible might not survive or might not be consequential.

> "Significant policy surprises, and significant changes in company stock prices, lurk in the near- and not-so-near-term future."

It is important to stress that all of these responses were based on conjecture. Substantial new information will unfold as Trump's presidency progresses. Important elements of short-term expectations regarding policies and their effects on company fortunes, whether for the day following or the seven weeks following election day, may well reverse themselves when policies are actually implemented. Whatever one's politics, the initial days of Trump's presidency mean that at least one prediction can be made with some confidence: significant policy surprises, and significant changes in company stock prices, lurk in the near- and not-so-near-term future.

The full paper can be found at http://bit.ly/2mhBFbF.

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